IT 00-0018-GIL 03/02/2000 ALTERNATIVE APPORTIONMENT

General Information Letter: Petition to eliminate throwback sales from the Illinois numerator cannot be granted without showing that the statutory apportionment formula fails to fairly represent the extent of the taxpayer's business activity in Illinois.

March 2, 2000

Dear:

This is in response to your letter dated January 14, 2000, in which you request permission pursuant to Section 304(f) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 101 *et seq.*) for xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx to exclude from the numerator of its sales factor gross receipts ordinarily included in the numerator pursuant to the so-called "throwback rule" in Section 304(a)(3)(B)(ii) of the IITA. The nature of your letter and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. *See* 86 Ill. Adm. Code 1200.120(b) and (c), enclosed. For the reasons discussed below, your petition cannot be granted at this time.

In your letter you have stated the following:

> Pursuant to Illinois Income Tax Act Section 304(f), xxxxxxxxxxxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxx ("xxxxx"), hereby petitions the Director of the Illinois Department of Revenue for use of an alternative method to effectuate an equitable apportionment of xxxxxxx income for the tax year ending December 31, 2000.[1] For the reasons stated below, the use of the allocation and apportionment provisions of IITA Secs. 304(a) and 304(e), and of IITA Sec. 304(h), would not fairly represent the extent of Rhone's business activity in Illinois.[2]

BACKGROUND FACTS

xxxxx is a xxxxxxxx corporation headquartered in xxxxxxxxxxxx, xxxxxxxxxxxx. xxxxx manufactures and markets a wide variety of pharmaceutical products for use in such therapeutic categories as thrombosis, oncology, asthma, allergy, women's health, children's health, central nervous system, and anti-infectives. xxxxx maintains a state-of-the-art distribution facility in xxxxxxxxxx, Illinois. xxxxx uses this climate-controlled facility to store fragile plasma products and other pharmaceuticals. xxxxx also uses this facility to warehouse products that xxxxx manufactures at locations outside this State before distribution to purchasers. A significant percentage of the xxxxx products that are shipped from the xxxxxxxxxxx facility are to purchasers in states where xxxxx is not taxable.

xxxxxxxxxxxxxxxxxxxxxxxxx ("xxxxxx"), one of xxxxxxx unitary business affiliates, is also a xxxxxxxx corporation headquartered in xxxxxxxxxxxx, xxxxxxxxxxxx. xxxxxx is engaged in producing a full line of high quality prescription and over-the-counter products used by dermatologists and other physicians to treat a wide range of skin problems. Many of the products manufactured by xxxxxx are stored at xxxxxxx facility in xxxxxxxxxxx before their ultimate distribution to purchasers throughout the United States. A significant percentage of the xxxxxx products that are shipped from the xxxxxxxxxxx warehouse are to purchasers in states where xxxxxx is not taxable.

xxxxxxxxxxxxx. ("xxxxxxx"), a joint venture between xxxxx and an unrelated company, maintains a manufacturing facility in xxxxxxxx, Illinois. xxxxxxx is a global leader in the plasma protein industry, and is engaged in making such products as coagulation therapies for the treatment of hemophilia; plasma-based wound-healing agents; immunoglobulins for the prevention and treatment of immune disorders; and albumin products for the treatment of a variety of conditions such as shock, burns, and circulatory disorders. xxxxxxx sells these products to purchasers throughout the United States. A significant percentage of xxxxxxxxx sales, that are shipped from its facility in xxxxxxxx, are to purchasers in states where xxxxxxx is not taxable.

THE REQUIRED APPORTIONMENT FORMULA WOULD NOT FAIRLY REPRESENT THE EXTENT OF xxxxxxx BUSINESS ACTIVITY IN ILLINOIS

Pursuant to IITA Sec. 304(a), for tax years ending on or after December 31, 1998, multistate taxpayers are required to compute their apportionment factor under the provisions of IITA Sec. 304(h). In accordance with IITA Sec. 304(h)(3), for tax years ending on or after December 31, 2000, the business income of a multistate taxpayer (like xxxxx) is apportioned to Illinois based solely on the taxpayer's sales factor.

Under IITA Section 304(a)(3)(A), the sales factor is a fraction, the numerator of which is the taxpayer's total sales in Illinois during the tax year, and the denominator of which is the taxpayer's total sales everywhere during the tax year. Pursuant to IITA Sec. 304(a)(3)(B)(i), sales of tangible personal property are "sales in Illinois" if the property is shipped to a purchaser located within Illinois. Pursuant to IITA Sec. 304(a)(3)(B)(ii), sales of tangible personal property are "thrown back" and are deemed to be "sales in Illinois" if the goods sold are shipped from a location within Illinois to a purchaser in a state in which the seller is not taxable.

As noted above, a significant percentage of the sales of goods made by xxxxx, xxxxxx, and xxxxxxx that are distributed from the xxxxxx xxxx and xxxxxxxx facilities are to purchasers in states where these three companies are not taxable. Consequently, in accordance with the provisions of IITA Secs. 304(a)(3)(B)(ii) and 304(h)(3), these sales would be thrown back and included in the sales factor numerators of the respective sellers. The application of the foregoing formula would not fairly represent the extent of the pharmaceutical business conducted in Illinois by xxxxx, xxxxxx, and xxxxxxx.

First, unlike the formula in effect for tax years prior to the year at issue here, the required formula would give xxxxx, xxxxxx, and xxxxxxx no credit whatsoever for the substantial contributions to income made by the labor and capital employed within Illinois by these three taxpayers. With the adoption of P.A. 90-613, Illinois lawmakers abandoned the payroll, property, and double-weighted sales factor these taxpayers previously used to apportion their income to Illinois in favor of the single-sales factor apportionment formula described above.

Under the old formula, the income of these taxpayers was apportioned to Illinois by multiplying their income by a fraction, the numerator of which was the sum of their payroll, property and twice their sales factors, and the denominator of which was four. *See* IITA Sec. 304(a). For purposes of this formulation, the property factor of these taxpayers was the ratio of the average value of their real and tangible personal property in Illinois over the average value of all their real and tangible personal property, and the payroll factor of these companies was the ratio of the total amount of compensation paid in Illinois over the total amount of compensation paid everywhere. *See* IITA Secs. 304(a)(1), (2).

The foregoing three-factor formula was derived essentially from the Uniform Division of Income for Tax Purposes Act. *See Caterpillar Tractor Co. v. Lenckos,* 84 Ill.2d 102, 120-121 (1981). With respect to the UDITPA apportionment regime, the U.S. Supreme Court has observed that the three-factor formula has gained wide approval because the payroll, property, and sales factors, in combination, reflect a large share of the activities by which value is generated. *Container Corp. of America v. Franchise Tax Bd.,* 463 U.S. 159 (1983). The practical meaning of the Court's observation here is of course that there should be some relationship between the source of income included in the apportionable tax base and the factors actually used to apportion that income.

Along these lines, in *The New Yorker Magazine, Inc. v. Department of Revenue,* 187 Ill. App. 3d 931, 943 (1st Dist. 1989), the Appellate Court stated that Illinois' three-factor formula was designed to adjust for variations in any given facts so that the payroll, property, and sales factors together represented the taxpayer's "business activity" in Illinois. In similar fashion, in *Continental Illinois Bank and Trust Co. v. Lenckos,* 102 Ill.2d 210, 224 (1984), the Illinois Supreme Court stated that the purpose of this apportionment formula is to confine the taxation of apportionable business income to that portion of the taxpayer's income which is fairly attributable to the activities undertaken in Illinois by the taxpayer. *See also Caterpillar*, 84 Ill.2d at 123 (the three-factor formula was designed to confine the taxation of income by Illinois to the portion of the taxpayer's income that is attributable to the taxpayer's in-state activities).

Insofar as the payroll and property factors are no longer components of the apportionment formula in Illinois, the application of the required formula would not fairly represent the pharmaceutical business conducted in this State by xxxxx, xxxxxx, and xxxxxxx, and would not reflect a large share of the activities by which their income will be generated in the year at issue. It is widely known that a taxpayer's income is generated primarily by the taxpayer's employment of labor and its allocation of capital, and not by its sales receipts. *See* J. Hellerstein & W. Hellerstein, State Taxation: Constitutional Limitations and Corporate and Franchise Taxes, 3d ed., ¶ 8.01[A], [B]. In this connection, it is the taxpayer's payroll and property factors, and not its sales factor, that are designed to reflect the essential contributions made by these elements in the production of the taxpayer's apportionable income.

For sales factor purposes, both UDITPA and the law in Illinois (specifically, IITA Sec. 304(a)(3)(B)(i)) adopt a "destination" test as the primary rule for determining where receipts from the sale of goods will be sourced. The principal author of UDITPA explained that the uniform act's destination test, whereunder sales of goods are assigned to the state of destination, was chosen over the "origin" test favored by tax authorities in certain manufacturing states. Pierce, William J., The Uniform Division of Income for State Tax Purposes Act, 35 TAXES 747, 780 (1957). According to Professor Pierce, the origin test, whereunder goods would have been sourced to the states from which the goods are shipped, was rejected on the ground that such a test *would merely duplicate the payroll and property factors*, which, by design, already take into account activities performed in the manufacturing or origin state. *Id.* (Emphasis added).

xxxxx itself maintains millions of dollars of inventory in Illinois. In addition, in this State, xxxxxxx alone has nearly $100 million in machinery and equipment, owns land and buildings valued at approximately $20 million, and owns or leases real and tangible personal property totaling nearly $200 million in value. Moreover, xxxxxxx itself pays wages in Illinois in excess of $50 million. The U.S. Supreme Court and the courts in this State have recognized the fundamental principle that there must be some relationship between the income in a taxpayer's apportionable tax base and the formula used to apportion that income *See Container Corp.*, 463 U.S. at 183; *see also, The New Yorker*, 187 Ill. App. 3d at 943.[3]

In that the required apportionment formula does not in any way account for the significant amounts of labor and capital employed by xxxxx, xxxxxx, and xxxxxxx at the xxxxxxxx and xxxxxxxxxxx facilities, there is *no relationship* between the taxpayers' respective apportionable incomes and the formula used to measure what portion of that income is attributable to the manufacturing and warehousing activities actually performed in this State by these taxpayers. Moreover, the value added to the goods shipped from Illinois through labor and capital employed by these taxpayers outside this State is likewise completely unrepresented in an apportionment regime that assigns their income exclusively by reference to where their pharmaceutical products are sold. For these reasons, the application of the required formula would not fairly represent the extent of the business activities in Illinois of these taxpayers.

Second, the application of the required formula would also be unfair to the extent that the formula counts as "Illinois sales" those sales of goods that are shipped from the xxxxxxxx and xxxxxxxxxxx facilities to purchasers in states where xxxxx, xxxxxx, and xxxxxxx are not taxable. As noted above, as the Illinois Supreme Court has found, the purpose of Illinois' three-factor formula is (was) to confine the taxation of apportionable income to that portion of the income which was fairly attributable to the taxpayer's business activities in Illinois. Accordingly, insofar as the required formula *simply deems* as Illinois business activities (i.e., sales) that unquestionably take place in other states, the formula would vitiate the very purpose of the formula in the first place.

The sales factor is designed not to reflect where a taxpayer maintains its production facilities, its warehouses, or its workforce; that is what the payroll and property factors are designed to do. Rather, as the principal author of UDITPA commented, the basic purpose of the sales factor is to reflect the contribution of the market state toward the production of the taxpayer's apportionable income. Pierce, at 780. Thus, in that Illinois is not the market state for most of the goods shipped by xxxxx, xxxxxx, and xxxxxxx from the xxxxxxxx and xxxxxxxxxxx facilities, it cannot fairly be said that Illinois actually contributed to the production of their apportionable incomes.

In this sense, by crediting Illinois for contributions to the incomes of xxxxx, xxxxxx, and xxxxxxx that are actually made by other states, the required formula would produce an unfair representation of the extent of the pharmaceutical business conducted in Illinois by these taxpayers. The unfairness of this feature of the required formula is compounded by the absence of payroll and property factors from the apportionment regime. By not taking into account the substantial contributions to income made by the labor and the capital employed in Illinois by these companies, and by deeming business activities that take place in other states (i.e., sales) to be Illinois activities, the required formula would unreasonably and arbitrarily attribute to Illinois a percentage of income that is out of all proportion to the pharmaceutical business transacted in Illinois by these three taxpayers.

THE PROPOSED ALTERNATIVE METHOD FAIRLY AND ACCURATELY APPORTIONS INCOME TO ILLINOIS

A more equitable allocation and apportionment of the incomes of xxxxx, xxxxxx, and xxxxxxx could be effectuated as follows: xxxxx petitions for the use of the single-sales factor, without application of the provisions in IITA Sec. 304(a)(3)(B)(ii). This method would assign to Illinois income attributable to the contributions made by the market states where xxxxx, xxxxxx, and xxxxxxx have most of their customers. As a consequence, insofar as this method would confine Illinois' taxation of income to that portion of these taxpayers' incomes that is fairly attributable to their activities in this State, this method would more fairly represent the extent of these taxpayers' pharmaceutical businesses in Illinois.

Response

Section 304(f) of the IITA provides:

> If the allocation and apportionment provisions of subsections (a) through (e) and of subsection (h) do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Director may require, in respect of all or any part of the person's business activity, if reasonable:
>
> (1) Separate accounting;
>
> (2) The exclusion of any one or more factors;

(3) The inclusion of one or more additional factors which will fairly represent the person's business activities in this State; or

(4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

Taxpayers who wish to use an alternative method of apportionment under this provision are required to file a petition complying with the requirements of 86 Ill. Adm. Code Section 100.3390, a copy of which is enclosed. 86 Ill. Adm. Code Section 100.3390(c) provides, in part:

> The party (the Director or the taxpayer) seeking to utilize an alternative apportionment method has the burden or going forward with the evidence and proving by clear and cogent evidence that the statutory formula results in the taxation of extraterritorial values and operates unreasonably and arbitrarily in attributing to Illinois a percentage of income which is out of all proportion to the business transacted in this State. In addition, the party seeking to use an alternative apportionment formula must go forward with the evidence and prove that the proposed alternative apportionment method fairly and accurately apportions income to Illinois based upon business activity in this State.

In your request, you assert that there are two areas in which the apportionment formula prescribed in Sections 304(a) and (h) of the IITA does not fairly represent extent of the business activities of xxxxx, xxxxxx and xxxxxxx in Illinois. First, you state that the prescribed formula fails to take into account the employment of labor and capital in Illinois by these taxpayers through their production and warehousing activities. Second, you state that the application of the so-called "throwback" rule in Section 304(a)(3)(B)(ii) of the IITA causes the sales factor to improperly represent the taxpayers' "market state" activities in states in which the taxpayers are not subject to income tax, because the throwback sales reflect the taxpayers' production and warehousing activities in Illinois rather than the "market state" activities.

The solution you request is to exclude the "throwback" sales from the numerator of the Illinois sales factor. This solution does not address the first problem you identify, which is the statutory apportionment formula's failure to reflect the taxpayers' production and warehousing activities in Illinois. To the contrary, to the extent the throwback rule reflects the taxpayers' warehousing activities in Illinois, excluding throwback sales will exacerbate this problem.

Accordingly, assuming for the sake of argument that the description and analysis of the problems identified in your request are sufficient to meet your burden of proof in showing that the statutory apportionment formula "operates unreasonably and arbitrarily in attributing to Illinois a percentage of income which is out of all proportion to the business transacted in this State," you have made no showing that your proposed apportionment formula "fairly and accurately apportions income to Illinois" because it in fact exacerbates one of the problems you identify with the statutory formula. In order for your request to be granted, the apportionment formula you propose must at least address both of the problems you have identified.

Please note that 86 Ill. Adm. Code Section 100.3390(e)(1) requires a petition to be filed at least 120 days prior to the due date (including extensions) for the first return for which permission is sought to use the alternative apportionment

method. Your petition filed January 14, 2000, will allow the taxpayers to use the requested method on original returns due on or after May 15, 2000, if granted.

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you still believe that your petition should be granted, please supplement the petition in accordance with the provisions of 86 Ill. Adm. Code Section 100.3390.

Sincerely,

Paul S. Caselton
Deputy Chief Counsel -- Income Tax

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[1] References to sections of the Illinois Income Tax Act are hereafter designated as "IITA Sec. __".

[2] xxxxx files its Illinois income tax returns on a combined basis with two of its affiliates (discussed below). This petition is submitted on behalf of xxxxx and these affiliates.

[3] Indeed, this fundamental principle would seem to call into question the continuing validity of a provision in the Department's "business income" regulation. According to 86 Ill. Adm. Code Sec. 100.3010(d)(3), a taxpayer's "business income" will include gain from the disposition of property if the property was used in the taxpayer's trade or business. Yet, under the required formula, such an income-producing asset is not even counted in the formula used to measure what portion of the gain from the sale of that asset is taxable in Illinois.